2006

OFHEO Fannie Mae Report of Annual Examination, 2006

United States: Office of Federal Housing Enterprise Oversight (OFHEO)

Federal National Mortgage Association
3900 Wisconsin Avenue NW
Washington, D.C. 20016

TABLE OF CONTENTS

EXAMINATION AUTHORITY AND SCOPE

Examination Authority and Reporting Convention

This Report of Examination contains the results and conclusions of OFHEO's 2006 annual examination of the Federal National Mortgage Association ("Fannie Mae" or the "Enterprise") performed under section 1317(a) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (12 USC § 4517(a)). The OFHEO annual examination program assesses the Enterprise's financial safety and soundness and overall risk management practices. OFHEO utilizes a "CAMELSO" methodology (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk, and Operations) similar to that adopted by the federal depository institution regulators to report examination results and conclusions to the Board of Directors and to Congress.

2006 Examination Scope

Our examination activities focused on supervision provided by senior management, enterprise risk management and internal audit, corporate governance functions, internal controls, information technology, credit risk management, accounting practices, and compliance with the requirements of the September 2005 Agreement and the May 2006 Consent Order. Our supervisory activities also included reviews of asset quality, counterparty concentration risk management, market and interest rate risk management practices, earnings performance, capital adequacy, and liquidity.

Rating

The Composite rating is 3 on a scale of 1 to 5. Entities rated 3 exhibit a combination of financial, non-financial, operational or compliance weaknesses ranging from moderately severe to unsatisfactory. When weaknesses relate to financial condition, such Enterprises may be vulnerable to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting the areas of weakness. An Enterprise that is in significant non-compliance with laws and regulations may also be accorded this rating. Generally, entities with this composite rating give cause for supervisory concern, because the weaknesses create some possibility of failure and they require more than normal supervision to address deficiencies. Overall strength and financial capacity, however, are still such as to make failure unlikely. Definitions for all composite ratings can be found in OFHEO's Supervision Handbook.

EXAMINATION CONCLUSIONS

The Enterprise is a significant supervisory concern. Although progress has been made in correcting deficiencies, significant issues remain and are centered in data, systems, controls, and risk measurement and management. Data and systems limitations have generated pervasive access control deficiencies, the inability to measure several risks with the highest degree of accuracy, and the inability to establish controls that meet industry standards in many areas. These limitations coupled with incomplete metrics adversely impact report accuracy and meaningfulness, impeding communication and the management of operations, risk and performance. Risk management deficiencies are most acute in the Housing and Community Development business unit and the management of counterparty exposure aggregation. Some limits in corporate policies need strengthening, and the development of many management policies and written procedures are in the initial stages. Several necessary positions in risk management, and model development and validation have been difficult to fill due to external factors.

Management has devoted substantial effort to address the Enterprise's deficiencies, but corrective programs are in varying stages of completion and many are in their initial stages. Financial statements for the years 2002 through 2004 were completed, but substantial work remains to complete years 2005 and 2006, and become a current filer. Significant progress has been made in initiatives needed to launch corrective programs in such areas as corporate policies, organizational structure, personnel numbers and expertise, risk measurement, and controls that correct or partially mitigate many deficiencies. In addition, the independent oversight functions have appropriate expertise and authority, and have been key drivers in addressing control and risk management issues in the business units. Management has demonstrated its ability to plan, prioritize, monitor, and control major projects. These efforts have built the foundation for future progress.

The Enterprise has: (1) a qualified and active Board of Directors, as well as a senior management team with an incomplete supervision program but that is in progress and has begun to improve the Enterprise, (2) operations with significant control deficiencies, that adversely impact risk management and expansion into new products, (3) weaknesses in several areas of credit risk management but strong asset quality, (4) minimally satisfactory interest rate risk management program with deficiencies in interest rate risk measurement, (5) satisfactory management of liquidity, (6) fair earnings, and (7) adequate regulatory capital and limits. Current and future earnings are adversely impacted by declining net interest margins, and competitive pressures. Structural and economic issues in the mortgage markets and the Enterprise's desire to expand activities in higher risk products heighten the importance of developing economic capital measures to better quantify risks and performance, as well as stronger financial performance measurement and attribution analysis.

MATTERS REQUIRING BOARD ATTENTION

The Board should take action or provide strong oversight to:

- Monitor project management for operations, information technology, internal control, and measurement of risk and performance. Evaluate the Enterprise-wide plan for the prioritization and coordination of projects, and the impact and reason for delays. Ensure interim processes and controls are completed and regularly audited until long term, sustainable solutions for data and systems are finalized. Ensure project management in all key areas of change.

- Ensure management completes its formal structure for decision protocol and the escalation of issues; business unit risk management; optimized pricing and measurement of risks and performance; and the coordination and rationalization of activities among the business units.

- Approve strengthened corporate limits for interest rate risk. Ensure business unit policies and written procedures are completed, and that all policies and limits are periodically updated, and incorporated into business practices.

- Ensure management improves the reporting of risks, performance, and operational issues through the use of accurate information and Enterprise-wide and business unit metrics, and summary reports for the Board and senior management that highlight key information and issues.

- Ensure management has completed an infrastructure that has sufficient data, information technology systems, controls, reports, and personnel in place before the Enterprise significantly engages in new products.

- Monitor management's progress toward remediating the significant number of internal control deficiencies to enable the release of accurate and timely financial statements. This remediation should permit a return to controls based auditing and ensure a sustainable control environment for financial reporting.

BOARD AND MANAGEMENT SUPERVISION

Board of Directors

The Board improved its structure and operations during the year through better policies, strengthened organizational structure and expertise, and better information flow with the business units and independent oversight functions. Continued oversight is needed to ensure the appropriate planning, prioritization, control, and completion of the myriad of projects and changes in progress. Risk and performance metrics are incomplete, preventing or impeding effective and standardized communication.

Corporate policies were approved around YE05, and were largely satisfactory. The Board's annual review is expected to result in needed improvements for some limits, such as interest rate risk limits for large market rate moves.

The Board's structure was strengthened through a revised committee structure and increased Board independence. The charters were rewritten for all six committees. The two new committees address risk management, and technology and operations. Independence was improved with independent directors on the Compliance committee, and the separation of the positions for CEO and Chairman of the Board in 2005. Six new Board members brought needed expertise in accounting, finance, and business operations.

Communication was improved through more accurate and complete management presentations, candid information from independent oversight functions, and improved reports in areas such as internal audit and interest rate risk. However, communication will remain impaired until management, the Housing and Community Finance committee, and the Risk Policy and Capital committee complete the development of corporate metrics for risk, performance, and operations.

Management and Human Resources

Management's supervision program is incomplete, and uncorrected deficiencies continue to adversely impact or impede effective supervision and decision making for the Enterprise. Management made significant progress in building a program that will allow for improvement in the future, but many programs and corrective actions are in their initial stages.

Deficiencies in management are centered in controls, communication, and information used in managing risk, performance, and operations. Corporate policies are largely complete but some corporate limits need strengthening, and management policies and written procedures are in varying stages of completion. Communication has improved, but the inadequate escalation of a few issues indicated continued weaknesses in the information flow from middle management. Issues in data and systems coupled with varying quality in report content and format impact the quality and meaningfulness of many summary and executive management reports. The issues in reports and metrics impede a comprehensive understanding of all key issues by all executive management, and the optimization of risk and performance management.

During the year, some business activities were poorly managed or little progress was made on projects. The lack of a satisfactory vendor management program coupled with the large increase in vendors fostered excessive costs, and contributed to events in fraud and the misuse of information. Aggregated counterparty credit risk was improperly reported, reducing the effectiveness in managing counterparty risk. Significant efforts failed to generate a complete program to correct deficiencies in the Acquisitions, Development and Construction (AD&C) department during 2006 due to the magnitude of necessary changes. Although management expended significant efforts to correct these deficiencies once the issues were discovered or understood, much work remains to be done.

In several areas, management has made significant progress in addressing controls, and building a structure and programs which will allow for future improvements. Corrective projects were initiated for major deficiencies in all business lines. Critical projects were satisfactorily planned and prioritized, and addressed both interim solutions as well as long term programs to address the Enterprise's deficiencies. However, progress varied widely due to the focus and resource demands needed to address financial reporting and disclosure issues. Efforts appropriately focused on the Restatement project, accounting policies, and control issues in the Controller department, but delayed several critical but lower priority projects needed for current production. Major progress was made in several areas, which include:

- Revising and implementing new organizational structures for management committees, business units, and independent oversight, and providing independent oversight with appropriate authority.
- Significantly improving the coordination and communication among business units as well as new and long-time personnel. Improving accountability for management and staff.
- Improving Board-level risk policies and limits.
- Hiring management and staff who bring needed expertise in industry standards.
- Remediating the identified Sarbanes Oxley control deficiencies.
- Formalizing of the delegations of authority for SVPs and higher was complete at YE06.
- Initiating quality control programs, such as the pilot leading to corporate-wide use of lean six sigma concept.

Management has substantially improved the number and expertise of management and staff. Personnel numbers have increased by about 18% over the past two years, with the increase focused on staff to strengthen controls, governance, and risk management. Over 35% of senior management positions and 53% of all officer positions are filled with outside hires. Management continues its efforts to fill vacancies, which are centered in model development and validation, and risk management in Housing and Community Development. Delays in hiring have largely been due to external factors.

Enterprise Risk Management

The Chief Risk Officer (CRO) division was substantially improved during 2006, and the function accelerated improvements during the last half of 2005 as the permanent management team was hired. The CRO is addressing issues associated with the newness of the function, which include insufficient staffing levels, and independent metrics, reports and risk measurement. Risk officers in the business units monitor risk and coordinate risk management with the CRO division, Internal Audit, and the Compliance and Ethics division, but improvements are needed in expertise and time devoted to risk management.

The CRO division has been instrumental in improving business unit controls and standards, and introducing discipline and formal limits and approval processes for controlling risks and activities. Management and staff are technically strong, and worked with the business units to incorporate industry standards or best practices into their policies, operations, and risk management. The independence of the CRO division will remain compromised until its work in building out the business units' programs is complete, and it has access to reports that are produced independent from the business units.

Audit

The Audit department exhibited weakness most of the year due to a program with deficiencies or inefficiencies in policies, quality and numbers of management and staff, and its programs for managing the audits and the department's administration. However, Audit management's significant efforts and continual improvements throughout the year addressed the department's deficiencies, culminating in a satisfactory program at YE06.

The Audit department exhibited deficiencies throughout its program that stemmed from former management. The new Chief Audit Executive developed a program that prioritized and corrected the issues. Major accomplishments include appropriate independence and authority, satisfactory risk assessment methodology applied to a sufficiently granular audit universe, meaningful communication and reports for the Board and business unit management, the build out of the audit management team, and efforts that have significantly contributed to the improvement of business unit controls and standards.

During 2006, OFHEO did not rely on completed audits to support examination activities, but will evaluate the appropriateness of reliance on Internal Audit work in 2007. OFHEO will not rely on audit work until a sufficient history in traditional audits is established.

Compliance

The new Compliance and Ethics division made substantial progress in building its organizational structure, and initiating programs to meet its function. However, significant work remains in completing its projects and coordinating an efficient program with the business units. Major accomplishments include coordinating with the Board and management compliance committees, completing the employee code of conduct, coordinating Consent Order compliance, as well as substantial progress in formalizing delegations of authority; standardizing policies and procedures; establishing a centralized policy repository; and improving regulatory protocol with OFHEO.

Accounting

Management has completed an evaluation of the Enterprise's accounting policies, and has in part provided OFHEO with documents responsive to the requirements of OFHEO's Accounting Guidance. However, significant risks remain in that Fannie Mae is currently not producing timely quarterly and annual financial reports. The current financial reporting environment has proven stable enough to produce financial statements related to the Restatement, but the Enterprise is not currently under the tight reporting timeframes that would be required of a timely filer and therefore it remains to be seen if the processes it is developing are robust enough to handle the task.

Fannie Mae made progress in 2006 to returning to timely financial reporting, by completing the restatement of 2002, 2003 and select 2004 information. Deloitte & Touche performed a substantive based audit of the 2004 financial statements. The Deloitte & Touche report disclaimed an opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, because of a scope limitation. The Enterprise's external auditor's report also expressed an adverse opinion on the effectiveness of the Enterprise's internal control over financial reporting as of December 31, 2004, because of material weaknesses and the effects of a scope limitation. Deloitte & Touche issued an unqualified opinion on Fannie Mae's 2004 financial statement.

The Enterprise has begun effecting change in its control environment; however, a significant number of control deficiencies still remain. Given the control deficiencies that are applicable to the financial statements, remediation efforts remain a critical concern. The Enterprise has made significant progress on the implementation of Section 404 of the Sarbanes-Oxley Act of 2002; however, the Enterprise's SOX remediation is still in progress. The Enterprise is making significant progress towards closing its high and medium ranked 2005 deficiencies that were pervasive; nevertheless, remediation of control deficiencies related to Disclosure Controls, and Financial Statement Preparation and Reporting remain open.

Model Risk

The significant shift in business unit and CRO resources to the Restatement has appropriately focused efforts on developing and validating financial reporting models, which represent many of the Enterprise's highest risk models. However, this shift caused significant delays in developing, implementing and/or validating other models that represent high to moderate risk. Validation work has been expedited with an incomplete CRO staff coupled with the use of consultants. Management plans to transition model development staff from Restatement and Catch-up efforts as their work is completed, which should allow the results of their work on current production models to be in effect by late 2007. However, the results from several models cannot achieve the highest degree of accuracy until Technology, Data, and Operations (TDO) addresses the Enterprise's data quality issues.

Significant progress has been made towards the development of a revised model risk management program. The program design is satisfactory, but work remains in implementing a fully functional program. Organizational structure and processes redesigned include model development, operation, independent validation, documentation, and other controls. Corporate policies are satisfactory, and written procedures are incomplete but in progress. The model inventory is complete, and progress was made in independently validating key models and some types of documentation. The Business Analytics & Decisions division (BA&D) is in the process of addressing outdated assumptions that introduce some level of uncertainty into the single-family Creditworks' suggested guaranty fee, and other models' results. Program implementation has been slowed by Restatement and Catch-up efforts, and the need for additional qualified developers in BA&D.

OPERATIONS

Operations controls are weak but improved. Poor or manually intensive controls for many processes continue to represent moderate to significant deficiencies throughout the Enterprise. Manual controls have reasonably addressed several significant deficiencies, but many cannot be fully corrected for years until improved and integrated systems fully automate processes. Control issues noted during 2006 include:

- Controls in many areas are manually intensive and/or do not meet industry standards primarily due to systems deficiencies. Many corrective actions provide the best controls possible in the current systems environment, but cannot fully mitigate the risks in reconciliations, report accuracy, access to data and systems, and segregation of duties. Some mitigating controls have not been proven sustainable. Material weaknesses exist in systems access controls.

- Management policies and written procedures used to communicate and standardize controls are incomplete. Metrics for risk, performance, and operations are being developed, but additional work is needed to define the metrics before this project can be completed.

- Many reports are not meaningful due to deficiencies in accuracy, timeliness, or report content. Summary or executive management reports do not provide or highlight all needed information. In addition, the Chief Risk Officer division does not have access to reports produced independently of the business units.

Management has devoted substantial effort to improve controls, but corrective programs are in varying stages of planning and implementation. Management has established the foundation for programs that have addressed several deficiencies, and has plans to improve operational processes and controls, and IT data and systems over time. Significant progress has been made in initiatives needed to launch the corrective programs in such areas as policies, staffing, and organizational structure. In addition, management has demonstrated its ability to plan, prioritize, monitor, and control projects. Deficiencies in vendor management and improper access to nonpublic information were addressed with actions that focused on both the specific issue and the root cause to address its impact on other Enterprise activities. Major areas of improvement or accomplishments include:

- The Restatement project was satisfactorily planned, implemented, and controlled, using end-to-end work streams, which will help in completing the 2005 and 2006 financial statements. Many deficiencies in controls for Sarbanes Oxley requirements have been addressed. However, significant work remains to rework Restatement operations into Catch up and Get Current operations, incorporate GAAP compliant accounting functions, and then integrate with existing production operations.

- By late 2006, operations were centralized in an independent business unit, Technology, Data, and Operations (TDO). TDO has been reorganized and new management is developing plans to address deficiencies in operations and information technology (IT).

- Corporate policy for operations is complete, but management policies and written procedures will require substantial effort to complete.

- The CRO, Internal Audit, Chief Compliance Officer, and the Sarbanes Oxley review function are building and coordinating independent oversight of operational activities.

- Many issues in end user computing were satisfactorily addressed and controlled.

- Controls in Treasury operations were improved to reasonably mitigate deficiencies identified in wire transfer segregation of duties.

Information Technology

Most of the Enterprise's IT back-end and accounting applications are aging platforms and legacy business applications, which have significantly contributed to an ineffective internal control environment. The systems are able to provide stable performance for traditional loan product transactions, but this is due to the significant level of support provided by experienced teams that can address production challenges. Systems limitations have generated pervasive access control deficiencies, the inability to establish segregation of duties controls that meet industry standards, and deficiencies in conducting and controlling accounting and transaction processing and reconciliation. Data repository and platform deficiencies impact the ability to produce accurate and timely performance and risk information for internal use and external disclosures. Significant work remains to integrate Restatement, Catch-up and Get Current operations, and GAAP-compliant accounting functions with current production operations.

Resources remained strained throughout 2006 due to the cumulative effect of maintaining normal business operations and improvements while also addressing inconsistent data repositories, and legacy platforms and applications that are unable to meet changing business, market, and regulatory requirements. As work on past financial statements is completed, employees will devote more time to other critical assignments and their regular jobs, and consultants will be released as work on past financial statements is completed. However, the plan to transfer knowledge to employees as consultants leave is not complete. As management properly continues to reduce administrative expenses, care should be taken to ensure adequate resources are available to continue the improvements in this area.

Business continuity and crisis management is well controlled with recovery plans and redundant data, systems, and locations.

Management's efforts have improved but not fully addressed deficiencies, and programs are in varying stages of improvement.

- By late 2006, the management of the Enterprise's technology and business operations was centralized in an independent business unit. TDO, this new business unit, has been reorganized, and has new management.

- TDO has developed comprehensive plans to address or mitigate control deficiencies and data quality, but many aspects of these plans have not been finalized or fully implemented. New TDO management is reviewing plans for integrating data management requirements with data center architecture plans. Full implementation of the plans will take years.

- All data used in the Restatement was scrubbed for quality, but not all data used within Fannie Mae has been scrubbed. Unscrubbed data is used internally in some areas such as interest rate risk measurement, creating some level of inaccuracy in model results. Management expects all data will be accurate when financial statements are timely filed in 2008.

- Aggressive but achievable plans for many IT projects were executed primarily by contractors that doubled the IT staff. Deficiencies in contractor selection and management led to events that allowed for the potential misuse of customer nonpublic information, which could have jeopardized the Enterprise's reputation. Management began improving the process after these events, and has initiated several activities to improve controls over nonpublic information.

- Projects to develop systems for Servicer and Investor Reporting (SIR), Federal Reserve Daylight Overdraft requirements, and the segregation of FNM and MBS funds were well planned, appropriately integrating IT and business unit interests. However, the SIR project suffered several delays due to Restatement staffing requirements.

In late 2006, management initiated a stronger program to address its data issues, and revise the plan evaluate and improve IT throughout the Enterprise. Management expects major progress in both data and IT during 2007.

ASSET QUALITY AND CREDIT RISK MANAGEMENT

The overall asset quality is strong with all loan and security portfolios exhibiting favorable quality and performance throughout 2006. Credit risk increased slightly from growth in sub-prime and other non-traditional products, but currently represents a low impact to earnings and capital. Credit risk from sub-prime and non-traditional loans, and securities collateralized by them is maintained at low levels through underwriting standards, credit enhancements, and/or position limits. Credit risk in the Housing and Community Development (HCD) portfolio may be increasing given the sharp rise in Watchlist assets. There is no thorough analysis of the Watchlist to help in better estimating its potential impact to actual credit problems. Counterparty credit risk represents significant exposure for the Enterprise.

Credit risk management has improved, but significant deficiencies centered in Housing and Community Development (HCD) and counterparty credit risk management continue to impede its effectiveness. The business units expended substantial effort in correcting deficiencies during 2006 but progress varied significantly among projects and business units. Many of HCD's projects are in their initial stages. Data and systems issues continue to adversely impact report quality in nearly all areas of credit risk. HCD's Risk Office with oversight from the Chief Risk Officer (CRO) division were key drivers in correcting many issues in risk management, with the

CRO helping to compensate for insufficient levels of risk management personnel in the business unit. Anti-fraud detection methodologies were improved for both single and multi-family loans.

Single Family Business

Asset quality is strong due to a book of business that is mostly comprised of traditional mortgage products. Delinquencies remain low and manageable, with the serious delinquency rate at about 0.61% of the book, and losses at about 0.016**%**. Losses due to Katrina were low, and better than originally estimated. Higher risk products such as interest only, sub-prime, Alt-A, and negative amortization loans are growing, but are currently about 20% of the book of business. New initiatives target product growth in higher risk products, and management plans to achieve a 20% market share in sub-prime loans by 2011.

Deficiencies remain in policies, staffing, and report quality. Many of the policies and written procedures are outdated or incomplete. Additional staff is needed in risk management and some business units, with the deficiency most acute in Single Family Credit (SFC), which includes the management of counterparties for single family (SF) loans. Systems permit adequate service to clients for traditional loan products, but their deficiencies impact the Enterprise's ability to quickly introduce new products or enhancements. In addition, data and systems deficiencies continue to impact report design, accuracy, and functionality. Delegations of authority were approved at higher management levels, but must be completed for management at lower levels.

SF made progress in addressing the large number of operational, control, and risk management deficiencies. In addition, progress has been made in codifying and implementing policies and written procedures. Business processes were significantly improved in the National Underwriting Center, and the National Business Center. Loss management at the National Servicing Organization is now satisfactory.

Management completed or significantly improved several functions near YE06, and the changes will require time to determine their effectiveness. Executive management made progress in addressing issues in accountability and authority. The credit policy and limits for SFC and Counterparty were completed at YE06, and the business centers are in process of completing policies to help standardize their practices. Management is reengineering the credit risk management framework to build out processes and formalize authorities. Issues in report accuracy, content, and format are being evaluated by SFC. Staff numbers and expertise were improved in SFC, but vacancies remain. The quality assurance function for Product Acquisition Strategy and Support has nearly completed process flows and document procedures for the lender and investor channels. The loan loss reserve methodology used for all of FNM's mortgage products is reasonable.

Housing & Community Development - Multifamily Business

The multifamily portfolio's problem loans were a low impact to earnings during 2006 with serious delinquencies at 0.08% of the total portfolio and losses at 0.00006%. Losses were unusually low due to favorable sales of Other Real Estate Owned (REO) properties, unexpected favorable outcomes on workouts in the Gulf Coast Hurricane affected areas, and low severity levels on defaulted loans. Watchlist loans significantly increased during the first half of 2006 from 9% to 15.8% of the multifamily portfolio, raising credit quality concerns. The Watchlist is likely a conservative indicator of potential problems because the list includes loans with issues in documentation, reserves, and other issues not usually included in Watchlists. 6.7% of the Watchlist is comprised of loans with insufficient cash flows to cover debt payments. However, this likely overstates problem loans because some amount is comprised of loans in their prestabilization period, or loans for property rehabilitation underwritten with the expectation that the low or insufficient cash flow coverage is temporary.

HCD exhibits numerous deficiencies in controls, reports, policies and written procedures, and staff numbers and expertise. Data and systems issues coupled with a low degree of automation, adversely impacts the efficiency of operations; and the accuracy, completeness, and timeliness of risk management reports, impacting the ability to manage risks and make business decisions. These deficiencies were material in the Acquisitions, Development and Construction (ADC) program, and the program was closed until program deficiencies are corrected. Staff vacancies remain throughout HCD, and are primarily in risk management.

HCD management has developed a remediation plan and has made progress in correcting several of the division's deficiencies, but many projects are in their initial stages of correction and full implementation of the new program will take two to three years. The HCD risk management team, with oversight from the CRO division has been instrumental in ensuring HCD's improvements will meet industry standards. HCD's efforts have focused on a complete revision of policies and the organizational structure, the development of a new credit risk rating model, and the build-out of the operations and the credit risk management functions. The entire portfolio was risk rated by YE05, and a vendor is working with HCD management to develop a more rigorous risk rating methodology for the debt and equity portfolios. The Loss Mitigation unit provides improved and expanded coverage for problem assets. The HCD quality control process was improved and expanded to provide better coverage of HCD loans. Vacancies are being filled, but external factors have slowed progress.

Liquidity and Retained Mortgage Portfolios

The Liquidity Investment Portfolio exhibited high credit quality with 58% AAA, 26% AA, and 16% A rated securities at YE06. In the retained portfolio, asset quality is strong, with product losses controlled by collateral, insurance, and/or first loss coverage. Private label securities (PLS) are restricted to AAA rated product until program deficiencies are addressed. Traditional single family fixed-rate mortgages and securities collateralized by them represent about 48% of the portfolio, and all fixed rate product represents about 70%. ARMs, floaters, hybrids, and multi-family product are about 30%. PLS is about 10% of the portfolio and is mostly comprised of floating rate product. These categories overlap.

Systems deficiencies impact analysis and proactive management of the portfolio by preventing the generation of reports with sufficient granularity for the product sub-sectors of the portfolio. In addition, accounting, and operational constraints that contribute to lagged data for whole loans impedes active management planned in the future and potentially impacting return optimization. PLS management has improved with revised policies and timely Watchlist reports. However, systems, reports, and stronger, proactive analysis independent of the traders need strengthening before PLS rated lower than AAA are purchased. New mortgage revenue bond activity is commencing as systems and other issues are addressed. The CRO is a key driver in incorporating industry standards and the use of benchmarks in portfolio management.

Enterprise Counterparties

Risk from counterparties and concentrations in similar types of counterparties represent a significant risk for the Enterprise. The top nine mortgage servicers process 71% of the servicing book. The single largest servicing counterparty is Countrywide, which services 21% of the $2.1 trillion servicing book and 20% of the $90 billion PLS portfolio. Mortgage insurers also represent a significant level of counterparty risk for the Enterprise, with the top seven companies providing insurance for 17% of the $2.5 trillion book of business.

The business units use basic practices in several aspects of risk management for individual counterparties. Counterparties are evaluated with credit risk ratings, financial statement analysis, and/or on-site visits. Risks from servicers are further managed with on-site reviews of operations and contract compliance as well as monitoring and coordination to address problem loans. Policies provide limits for individual counterparties based on a percentage of capital.

The program to identify, aggregate, and communicate counterparty risk is ineffective, but deficiencies are being addressed by an effort led by the CRO. Program deficiencies include:

- Exposure to individual counterparties is not properly aggregated, creating errors of varying degrees of magnitude. However, limits adequately controlled the risk that was actually measured for individual counterparties: 15 types of counterparty risk were not captured in the measurement.

- The Risknet system requires manual input, increasing the potential for errors. This proprietary system should be replaced with a vendor system that can provide cost effective functionality.

- Deficient Board reports do not provide complete or accurate information on aggregated exposure in counterparties.

Poor accountability and communication has contributed to the inconsistent escalation of problems in counterparty risk and other credit risk issues. Management's efforts culminated in formalized delegations of authority and better communication by YE06. However, past deficiencies resulted in the delayed communication of a significant issue to the CEO during 2005, which was not resolved until 3Q06.

- Countrywide stopped repurchasing certain problem loans despite its contractual obligation in 2004, allowing the loan volume to accumulate by mid-2005 to 2,400 loans. The CEO was not informed of this until late 2005. Negotiations between executive management and Countrywide resulted in an agreement in August 2006 which resolved the issue.

The CRO and business unit risk managers are correcting program deficiencies. The CRO and the newly created Potential Future Exposure Committee have identified previously uncaptured sources of counterparty risk. Improved exposure identification and measurement is underway, and the existing methodology is in use until better methods are established. The CRO began to improve the reports, and aggregate and monitor the risks in late 2006.

LIQUIDITY

Liquidity risk is low due to ample asset liquidity relative to net cash needs and management which is effective but requires improvement in minor to moderate issues with limits and operations. Portfolio securities provide strong coverage of FNM's net cash needs beyond 90 days, with the calculation using conservative values for the portfolio securities. Management has consistently maintained the liquidity investment portfolio in excess of 5% of portfolio assets. Asset liquidity places a high reliance on repurchase agreements (repo).

Board policies provide guidance for responsibilities, short term funding, liquid investment portfolio (LIP) credit quality, and the use of a severe scenario which assumes no new debt issuance for 90 days. Board and management policies were revised during 2006 to address requirements detailed in examinations and the September 2005 Agreement. These requirements include minimum net cash flow coverage provided by the LIP and repo, and the use of weighted average ratings to evaluate the LIP's credit quality. The revised policies are expected to be formally approved in early 2007. Management also amended policies to limit short term funding levels and concentrations of funding maturity dates.

Processes and controls for obtaining asset liquidity are satisfactory but inefficient and increase the potential for errors. Cash management processes are satisfactory due to recently improved automation of cash forecasting which provides real time monitoring of receipts and disbursements. However, the new repo funding process is not fully automated or intuitive, and the old system is proven but is only useful for moving large blocks of collateral during stress events. The repo operational impediments were largely mitigated when management began holding collateral at two other locations, coinciding with the successful completion of the Daylight Overdraft project in July 2006. Manual controls for wire transfer are adequate, but won't meet industry standards until operations are fully automated. Liquidity operations reorganization and centralization into the independent Operations business line was completed near YE06.

Liquidity is satisfactorily managed, with liquidity issues appropriately escalated through key management, the CRO, and committees based on set triggers. Reports used in the day to day management of liquidity are satisfactory, and include cash flow forecasts, assets available for repo or sale, and funding maturity concentrations. Although compliance with the conservative 90 day net funding coverage is analyzed and reported, stress scenario analysis should be strengthened with severe but realistic scenarios and semi-annual mock analyses based on specific stress situations.

SENSITIVITY TO INTEREST RATE RISK

Management adequately controls interest rate risk (IRR) with a minimally satisfactory risk management program that bases decisions on analytical tools, and some assumptions and data that require improvement. Operations are generally satisfactory but are inefficient in several areas, and manual controls reduce many key risks until processes are more fully automated. The Board policy satisfactorily addresses responsibilities and escalation triggers for approvals as risk increases, and provides an MVE limit for a moderate market rate move. However, Board and management policies need additional limits for large market rate moves, and to formalize management limits for contributing factors to IRR. Many of these issues are expected to be fully addressed during 2007, but several issues in systems and will require up to one year for correction.

Risk management practices are based on model results that are less than optimum but control IRR with reasonable accuracy. Unnecessary uncertainty in model results stems from the model's use of data with errors, some data that was inappropriately aggregated through much of 2006, and some assumptions that need review to ensure accuracy. In addition, the model and application use a portfolio settled book that is up to three months old and requires adjustments for seasoning and the addition of commitments to bring the book current. Monthly backtesting of reconciliations to actuals is used to ensure the adjustments used are reasonable estimates. During 2006, the completed first phase of the Portfolio Data System (PDS) Project improved risk measurement for debt, automated daily risk reporting, and provided an audit trail for assumptions. The Project's completion by YE07 is expected to address the data mapping and systems issues, and improve risk measurement. However, model results will not achieve the highest degree of accuracy until data quality issues are resolved.

Significant deficiencies in several fundamental controls for Capital Markets operations are being or have recently been corrected or mitigated. However, many deficiencies stemming from systems limitations will require roughly one year to correct due to their prioritization with the restatement and other significant projects, and integration with other systems. Operations management has reduced the risk in many critical control deficiencies with mitigating processes. The revision or creation of management policy and written procedures, and the creation and retention of documentation should be completed during 2007.

The Board policy provides an MVE limit only for a moderate move in market interest rates, but the Board policy should also include limits for larger rate shocks to formally control the complete risk profile. Management practices satisfactorily control IRR, but management policy does not have limits to formally control the contributing factors to IRR. Additional limits are expected to be added to the Board policy in early 2007, and management policies will be updated during 2007 to include formal limits for such areas as volatility, convexity, and key rate duration.

Management continues a program of effective risk management practices, and communication of IRR within Capital Markets. Risk is controlled and communicated through daily/weekly meetings of management and risk committees, and Board and management reports that provide sufficient information to understand the risk profile. Management and the CRO are discussing the use of daily profit/loss attribution, which will allow Capital Markets to achieve best practices in understanding and managing risk, as well as explain and improve total return performance.

The portfolios and related funding unhedged by derivatives represent a high level of risk. The quantity of risk for the portfolio hedged with derivatives is moderate due to the level of exposure from a significant move in longer term interest rates. The Board policy limits MVE sensitivity from the portfolios and related funding to $4 billion, or roughly 11% of pre-tax equity for a 50 basis point move in market rates. As of 9/26/06, the model-estimated MVE sensitivity for a 200 basis point upward move is $3.5 billion or 9% of MVE. The sensitivity for downward moves is significantly higher at $5.8 billion or 16% of MVE for 150 bp downward, and $11.5 billion or 32% for 200 bp due to proximity to peak convexity. The quantity rating is moderate due to the low probability that traditional fixed rate mortgage loan coupons are unlikely to decline 200 basis points, which at YE06 represented a 30-year fixed-rate mortgage loan coupon around 4%.

Management appropriately measures the IRR from the retained portfolio and funding, but does not also measure IRR for the entire GSE, which would allow management and the Board to understand the full impact of IRR to economic earnings and capital. The current measurement covers the retained portfolios and related funding, but does not include cash flows from the guaranty fee business.

Capital Markets' current reliance on delta hedging is used to hedge the portfolio's convexity through the active purchase and sale of swaps in an attempt to replicate the performance of options. This reliance could require access to significant amounts of swaps during a major market stress period that could impede rebalancing efforts. Capital Markets traders estimate that they can access up to $40 billion in 5-year swap equivalents per week in a normal market. This estimate indicates that traders would require about one week in 5-year swap equivalents to rebalance at YE06 for a 100bp rise in market rates without impacting the market price of swaps. In addition, this estimate indicates that management would require up to four weeks of 5-year equivalents for a 100 basis point decline through peak convexity, but in practice would likely be less due to the ability to use both swaps and MBS to hedge in this environment.

EARNINGS

Financial statements for 2005 and 2006 are un-audited, preliminary estimates subject to revision upon completion of the Restatement process. Fannie Mae's most recent publicly-disclosed financial statements are for the year ended December 31, 2004.

Based on unaudited results, earnings performance for 2006 is fair. GAAP net income during the period from 2002 to 2005 ranged from a high of $8.1 billion in 2003 to a low of $3.9 billion in 2002. GAAP earnings normalized for mark-to-market effects show a steady downward trend since 2003. The declining trend in net income continued during 2006 with annual earnings of $5.4 billion compared to $6.3 billion in 2005. A similar negative trend is exhibited in fair value earnings from 2003 to 2005 declining from $11.4 billion to $3.4 billion. The decline in net income for 2006 was primarily driven by a decline in net interest margin and increased administrative expenses.

Earnings have been volatile as a result of mark-to-market gains/losses on the derivatives portfolio, early debt retirement, and portfolio sales. Declining interest rates caused mark-to-market losses on derivatives during the second half of 2006. Fannie Mae internally reported a net loss of $396 million for the third quarter of 2006, a development which generated a supervisory response from OFHEO, in accordance with OFHEO's regulations.

Long-term declines in earnings are due to a number of factors, some of which are recurring and are likely to have a dampening effect on earnings going forward. The declining net interest margin combined with inability to grow the mortgage portfolio until full remediation of internal control deficiencies will likely impact future earnings because the mortgage portfolio currently generates a significant share of earnings. A flat yield curve and increased competition for mortgages contributed to the downward pressure on net interest margin in 2006. Since 2004, the net interest margin has declined by about 100 basis points, to 0.78 percent in the fourth quarter of 2006. Administrative expenses in 2006 were $0.9 billion higher than in 2005 as a result of restatement costs, regulatory compliance efforts, and higher staff levels and compensation.

The minimum capital surplus increased by $3.1 billion during the year to $4.2 billion in December 2006. Fannie Mae maintained a quarterly average minimum capital surplus of approximately $3.8 billion in 2006. Changes in the surplus were closely linked to changes in retained earnings.

Fannie Mae's core business continues to provide sources of significant recurring earnings. The decline in earnings from the retained portfolio is being partially offset by higher earnings from the credit guarantee business. Guarantee fee income increased by $0.9 billion in 2006 compared to 2005. Guarantee fee growth was supported by an annual increase in outstanding MBS of 11.4%, combined with a stable guarantee fee rate.

The loan loss reserve declined during 2006 to approximately $0.8 billion from $1.1 billion, resulting from a reduction in losses previously provisioned for Hurricane Katrina.

CAPITAL

OFHEO classified Fannie Mae as adequately capitalized for the first three quarters of 2006. OFHEO's Office of Capital Supervision formally classifies capital adequacy quarterly in accordance with Subtitle B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 and with the requirements set forth in OFHEO's minimum and risk-based capital regulations. The Enterprise is required by Federal Statute to meet both minimum and risk-based capital standards to be classified as adequately capitalized. The Enterprise is adequately capitalized and maintains satisfactory cushions above statutory, regulatory, and internally-mandated capital levels. OFHEO continues to evaluate and monitor the capital surplus, in part, due to the evidence of significant operational risk and control weaknesses cited throughout this report. Capital planning processes are satisfactory and assess risks throughout the company, although methods of measurement and analysis can be enhanced.

Fannie Mae remains subject to the requirements imposed by the Consent Order dated May 23, 2006 and the Capital Restoration Plan approved February 17, 2005. The Capital Restoration Plan required Fannie Mae to achieve a 30 percent capital surplus over the minimum capital requirement by September 30, 2005 (OFHEO-directed capital requirement). Fannie Mae is required to maintain a capital surplus above the OFHEO-directed requirement on an ongoing basis. Fannie Mae met the initial September 30, 2005 requirement of 30 percent surplus and it has continued to maintain the surplus throughout 2006. The Consent Order also directed Fannie Mae to limit growth of its portfolio mortgage assets. Fannie Mae has complied with the growth restrictions and appropriately incorporated these restrictions into its capital plan. During 2006, OFHEO emphasized the importance of maintaining the capital surplus in excess of the OFHEO-directed requirement given the lack of timely financial filing by Fannie Mae and the continued operational weaknesses. OFHEO also emphasized the importance of tying future common stock dividend increases with significant achievement of milestones to correct identified weaknesses, including becoming a timely financial statement filer.

On December 28, 2006, OFHEO announced that it had classified Fannie Mae as adequately capitalized as of September 30, 2006. As of that date, the core capital of the Enterprise exceeded its OFHEO-directed capital requirement by $4.294 billion, representing an 11.4 percent surplus over the OFHEO-directed capital requirement and a 44.8 percent surplus over the statutory minimum capital requirement. The September 30, 2006 capital results incorporate adjustments for the accounting impacts identified in the company's 2004 10-K, which was filed with the Securities and Exchange Commission on December 6, 2006. OFHEO classified Fannie Mae as adequately capitalized for the preceding two quarters of 2006, and will not issue the YE06 classification until March, 2007. Fannie Mae's capital plan describes how the Enterprise expects to maintain a surplus over the OFHEO-directed capital requirement through a combination of controlled growth and earnings retention.

During 2006, Fannie Mae has continued to enhance and refine its capital planning processes and produced an acceptable capital plan on a quarterly basis. However, OFHEO communicated a need for enhancements to the capital plan and management has initiated action to incorporate those enhancements appropriately and timely. Inconsistencies in the capital planning process were evident during 2006, highlighting the need to ensure better coordination and communication of corporate capital actions. Weekly management reports, which include current and projected capital trends and actions, provide senior management and the Board with effective tools to manage the capital position above OFHEO-directed requirements. Fannie Mae has conservatively managed the capital cushion during the ongoing financial restatement process to better ensure their ability to respond to unknown risks.

OFHEO's capital classification of Fannie Mae is based on Fannie Mae's best estimate of its financial condition, as certified and represented as true and correct to the best of Fannie Mae management's belief and knowledge. The September 30, 2006 capital classification, even though it incorporates adjustments for the accounting impacts identified in the 2004 10-K, remains subject to revision pending Fannie Mae's submission of audited 2006 financial statements and corresponding regulatory capital reports. First and second quarter 2006 capital classifications also remain subject to revision pending the submission of audited 2006 financial statements.